MSP #1

The Time for Tax Reform is Now

DEFINITION OF PROBLEM

The most serious problem facing taxpayers – and the IRS – is the complexity of the Internal Revenue Code.

ANALYSIS OF PROBLEM

The National Taxpayer Advocate on numerous occasions has identified the complexity of the tax code as the most serious problem facing taxpayers and urged Congress to simplify it. In this section, we discuss the sources and impact of code complexity and the practical obstacles to simplification. In an accompanying legislative recommendation later in this report, we outline principles and proposals that we encourage Congress to consider as it explores tax reform options.

A. Why is Tax Reform Needed?

1. The Current Tax Code Imposes Huge Compliance Burdens on Individual Taxpayers and Businesses.

Consider the following:

- According to a TAS analysis of IRS data, U.S. taxpayers and businesses spend about 6.1 billion hours a year complying with the filing requirements of the Internal Revenue Code.[1] And that figure does not include the millions of additional hours that taxpayers must spend when they are required to respond to IRS notices or audits. (For a breakdown of hours by tax form and information reporting document, see Table 1.1.1 at the end of this discussion.)
- If tax compliance were an industry, it would be one of the largest in the United States. To consume 6.1 billion hours, the "tax industry" requires the equivalent of more than three million full-time workers.[2]
- Compliance costs are huge both in absolute terms and relative to the amount of tax revenue collected. Based on Bureau of Labor Statistics data on the hourly cost of an

1 The TAS Research function arrived at this estimate by multiplying the number of copies of each form filed for tax year 2008 by the average amount of time the IRS estimated it took to complete the form. While the IRS estimates are the most authoritative available, the amount of time the average taxpayer spends completing a form is difficult to measure with precision. This TAS estimate may be low because it does not take into account all forms and, as noted in the text, it does not include the amount of time taxpayers spend responding to post-filing notices, examinations, or collection actions. Conversely, the TAS estimate may be high because IRS time estimates have not necessarily kept pace fully with technology improvements that allow a wider range of processing activities to be completed via automation. We note that the aggregate burden of 6.1 billion hours is lower than the 7.6 billion hour estimate included in our 2008 report. Analysts in the IRS Office of Research, Analysis and Statistics (RAS) have advised us that the lower burden estimates likely reflect efficiency gains attributable to wider use of tax software, particularly by higher income business taxpayers. However, these efficiency gains have not necessarily reduced the burden on middle income and lower income taxpayers. Indeed, measured by dollars, RAS estimates that the mean burden has declined but the median burden has increased. TAS cannot independently determine the margin of error of existing estimates, and RAS acknowledges that the reduction in the time burden estimates may be at least partially attributable to measurement error.

2 This calculation assumes each employee works 2,000 hours per year (*i.e.*, 50 weeks, with two weeks off for vacation, at 40 hours per week).

employee, TAS estimates that the costs of complying with the individual and corporate income tax requirements for 2008 amounted to $163 billion – or a staggering 11 percent of aggregate income tax receipts.[3]

- According to a tally compiled by a leading publisher of tax information, there have been approximately 4,428 changes to the tax code over the past 10 years, an average of more than one a day, including an estimated 579 changes in 2010 alone.[4]
- The tax code has grown so long that it has become challenging even to figure out how long it is. A search of the code conducted for this report turned up 3.8 million words.[5] A 2001 study published by the Joint Committee on Taxation put the number of words in the Code at that time at 1,395,000.[6] A 2005 report by a tax research organization put the number of words at 2.1 million, and notably, found that the number had *almost tripled* since 1975.[7]
- The income tax regulations issued by the Treasury Department to provide guidance on the meaning of the Internal Revenue Code now stand about a foot tall.[8] The CCH Standard Federal Tax Reporter, a leading publication for tax professionals that summarizes administrative guidance and judicial decisions issued under each section

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3 The IRS and several outside analysts have attempted to quantify the costs of compliance. For an overview of previous studies, see Government Accountability Office, GAO-05-878, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System* (Aug. 2005). There is no clearly correct methodology, and the results of these studies vary. All monetize the amount of time that taxpayers and their preparers spend complying with the Code. The TAS estimate of the cost of complying with personal and business income tax requirements (and thus excluding the time spent complying with employment, estate and gift, excise, exempt organization tax requirements) was made by multiplying the total number of such hours (5.6 billion) by the average hourly cost of a civilian employee ($29.18), as reported by the Bureau of Labor Statistics. *See* Bureau of Labor Statistics, U.S. Department of Labor, *Employer Costs for Employee Compensation – December 2008*, USDL: 09-0247 (Mar. 12, 2009) (including wages and benefits), *at* http://www.bls.gov/news.release/archives/ecec_03122009.pdf. The TAS estimate of compliance costs as a percentage of total income tax receipts for 2008 was made by dividing the income tax compliance cost as computed above ($163 billion) by total 2008 income tax receipts ($1.45 trillion). *See* Office of Management and Budget, Budget of the United States Government - Fiscal Year 2011, Historical Tables, Table 2-1, *at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/hist.pdf. TAS's estimate that compliance costs amount to about 11 percent of aggregate income tax receipts falls on the lower side of some previous estimates. For example, Professor Joel Slemrod computed that compliance costs constitute about 13 percent of income tax receipts, while the Tax Foundation computed that compliance costs constitute about 22 percent of income tax receipts. *See* Public Meeting of the President's Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Joel Slemrod, Paul W. McCracken Collegiate Professor of Business Economics and Public Policy, University of Michigan Stephen M. Ross School of Business), *at* http://www.taxreformpanel.gov/meetings/meeting-03032005.shtml; J. Scott Moody, Wendy P. Warcholik & Scott A. Hodge, *Special Report: The Rising Cost of Complying with the Federal Income Tax* (Tax Foundation, Dec. 2005), *at* http://www.taxfoundation.org/research/show/1281.html.

4 Unpublished CCH data provided to TAS (Dec. 22, 2010).

5 To determine the number of words in the Internal Revenue Code, TAS downloaded a zipped file of Title 26 of the U.S. Code (*i.e.*, the Internal Revenue Code) from the website of the U.S. House of Representatives at http://uscode.house.gov/download/title_26.shtml. We unzipped the file, copied it into Microsoft Word, and used the "word count" feature to compute the number of words. The version of Title 26 we used was dated Feb. 1, 2010, so the count does not reflect legislation enacted during the second session of the 111th Congress. In Word, the document ran 11,045 single-spaced pages. The printed code contains certain information that does not have the effect of law, such as a description of amendments that have been adopted, effective dates, cross references, and captions. Therefore, our count somewhat overstates the number of words that are officially considered a part of the tax code, although as a practical matter, a person seeking to determine the law will likely have to read and consider many of these additional words, including effective dates, cross references, and captions. It is possible that other attempts to determine the length of the Code have attempted to exclude some or all of these components, but there is no clearly correct methodology to use, and there is no easy way to selectively delete information from a document of this length.

6 *See* Staff of the Joint Committee on Taxation, 107th Cong., Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (vol. I), at 4 (Comm. Print 2001).

7 J. Scott Moody, Wendy P. Warcholik & Scott A. Hodge, *Special Report: The Rising Cost of Complying with the Federal Income Tax* (Tax Foundation, Dec. 2005), *at* http://www.taxfoundation.org/research/show/1281.html.

8 *See* CCH Income Tax Regulations (published as six volumes) or RIA Federal Tax Regulations (published as five volumes). Estate, gift, employment, and excise tax regulations are published in additional volumes.

of the Code, now comprises 25 volumes and takes up nine feet of shelf space.[9] Two companies publish newsletters *daily* that report on new developments in the field of taxation; the print editions often run 50-100 pages and the electronic databases contain substantially more detailed information.[10]

- The complexity of the Code leads to perverse results. On the one hand, taxpayers who honestly seek to comply with the law often make inadvertent errors, causing them to either overpay their tax or become subject to IRS enforcement action for mistaken underpayments. On the other hand, sophisticated taxpayers often find loopholes that enable them to reduce or eliminate their tax liabilities.
- Individual taxpayers find return preparation so overwhelming that about 60 percent now pay preparers to do it for them.[11] Among unincorporated business taxpayers, the figure rises to about 71 percent.[12] An additional 29 percent of individual taxpayers use tax software to help them prepare their returns,[13] with leading software packages costing $50 or more. IRS researchers estimate the monetary compliance burden of the median individual taxpayer (as measured by income) rose from $220 in 2000 to $258 in 2007, an increase of 17 percent.[14]

2. The Tax Code Is Rife with Complexity and Special Tax Breaks, Helping Taxpayers Who Can Afford Expensive Tax Advice and Discriminating Against Those Who Cannot.

Transparency is a critical feature of a successful tax system. It is essential if the system is to build taxpayer confidence and maintain high rates of tax compliance. No one wants to feel like a "tax chump" – paying more while suspecting that others are taking advantage of loopholes to pay less. Taxpayers who believe they are unfairly paying more than others inevitably will feel more justified in "fudging" to right the perceived wrong. And the complexity of the current system does, indeed, inflict a "wrong," providing a distinct advantage to taxpayers who can afford expensive tax-planning advice while, at least in relative terms, discriminating against taxpayers who do not have access to such advice.

The outcome of this situation is predictable – taxpayers develop a sense of cynicism about the tax system and the government that has foisted it on them, and tax compliance takes a hit.

Most Serious Problems

9 CCH Standard Federal Tax Reporter (2010).

10 These publications are *Highlights & Documents* (published by Tax Analysts) and the *Daily Tax Report* (published by BNA). According to the Federal Editor in Chief of Tax Analysts, *Tax Notes Today* (the electronic publication that serves as the main source for stories in *Highlights & Documents*) contains an average of 50-70 items a day.

11 IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2008); George Contos, John Guyton, Patrick Langetieg & Melissa Vigil, *Individual Taxpayer Compliance Burden: The Role of Assisted Methods in Taxpayer Response to Increasing Complexity* 7 (presented at IRS Research Conference, June 2010).

12 IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2008).

13 George Contos, John Guyton, Patrick Langetieg & Melissa Vigil, *Individual Taxpayer Compliance Burden: The Role of Assisted Methods in Taxpayer Response to Increasing Complexity* 7 (presented at IRS Research Conference, June 2010).

14 *Id.* at 26.

Dozens of tax breaks benefit narrow groups of taxpayers or industries. Here is a small sampling of narrow benefits, either intended or incidental, for which the average taxpayer does not qualify:

- **Black Liquor Credit.** This provision is generally intended as an incentive for "green" biofuel, but it allows paper mills to claim credit for a pulp by-product.[15]
- **Easement for Harmonious Shapes and Textures.** This provision allows donors of certain easements for conservation purposes to claim a charitable deduction, but it is almost impossible for the IRS to administer.[16] For example, it requires valuation of real property rights that preserve historic facades of houses or preclude development of open space, which under the tax regulations take into account such variables as the "harmonious variety of shapes and textures" on a landscape.[17]
- **Electric Vehicle/Golf Cart Credit.** This provision provides a credit for the purchase of qualified plug-in electric vehicles, which at one point included golf carts. While that loophole has been closed, the credit still covers the $100,000-plus Tesla sports car.[18]
- **Film and TV Deduction.** This provision allows taxpayers to expense costs associated with the production of films and television programs in lieu of the less generous depreciation deduction generally available to businesses.[19]
- **Forestry Conservation Bonds.** This provision authorizes a credit for investors in bonds issued by a government or nonprofit entity for the purpose of acquiring at least 40,000 acres adjacent to a national park, subject to a native fish habitat conservation plan of the U.S. Fish and Wildlife Service.[20]
- **Railroad Track Maintenance Credit.** This provision provides a special credit for taxpayers who happen to own a railroad.[21]

We acknowledge that tax incentives are enacted for legitimate reasons, including to encourage certain types of behavior or to provide benefits in certain circumstances. Nevertheless, when every interest group gets its own tax break, taxpayers worry that others are getting a better deal. Additionally, some taxpayers who could benefit from tax breaks fail to claim them because they do not know they exist.

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15 *See* IRC § 6426; *see also* Office of Management & Budget, *Budget of the United States Government FY 2011*, Analytical Perspectives, Ch. 14 (Federal Receipts) 177 (explaining that "byproducts derived from the processing of paper or pulp (known as black liquor when derived from the kraft process) . . . would qualify as cellulosic biofuel and, to the extent so qualifying, could result in substantial revenue losses and a windfall to the paper industry").

16 *See* IRC § 170(h).

17 Treas. Reg. § 1.170A-14(d)(4)(ii)(A)(5).

18 *See* IRC § 30D.

19 *See* IRC § 181.

20 *See* IRC § 54B.

21 *See* IRC § 45G.

In 2006, for example, taxpayers were permitted to claim a one-time tax credit for telephone excise taxes that the government had improperly collected.[22] The credit ranged from $30 to $60, depending on the number of personal exemptions the taxpayer was entitled to claim on the return.[23] No substantiation was required unless a taxpayer claimed a larger amount, so this credit was essentially free money. Yet IRS data show that 28 percent of eligible taxpayers (37 million out of 133 million) did not claim the credit.[24] Why would 37 million taxpayers fail to claim an authorized credit? The only plausible explanation is that they never learned about it because they were already so overwhelmed by the complexity of their tax returns.[25]

3. Complexity Obscures Understanding and Creates a Sense of Distance Between Taxpayers and the Government, Resulting in Lower Rates of Voluntary Tax Compliance.

Few Americans would steal from a local charity. Yet IRS data show that when taxpayers have a choice about reporting their income, tax compliance rates are astonishingly low. Workers who are classified as employees have little opportunity to underreport their income because it is subject to tax withholding. Employees thus report about 99 percent of their earned income. But among workers whose income is not subject to tax withholding, compliance rates plummet. IRS studies show that non-farm sole proprietors report only 43 percent of their business income and unincorporated farming businesses report only 28 percent.[26]

Tax noncompliance cheats honest taxpayers, who must pay more to make up the difference. According to the IRS's most recent comprehensive estimate, the net tax gap stood at $290 billion in 2001,[27] when 132 million tax returns were filed.[28] This means that each taxpayer was effectively paying a "surtax" of some $2,200 to subsidize noncompliance by others.

As the Administration and Congress assess our existing tax system, it is important to consider why tax compliance rates are so low among taxpayers whose income is not subject to withholding or reporting. Put simply, why would an individual who would never consider stealing from a local charity have little compunction about cheating on his taxes?

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22 *See* IRS Notice 2006-50, 2006-1 C.B. 1141. Unlike the other examples cited in this section, the telephone excise tax refunds were authorized by the Department of the Treasury after several circuits of the U.S. Court of Appeals ruled that the long-distance telephone services at issue were not subject to taxation.

23 IRS News Release, *IRS Announces Standard Amounts for Telephone Tax Refunds*, IR-2006-137 (Aug. 31, 2006).

24 IRS Office of Research, Analysis, and Statistics, Response to TAS Information Request (Dec. 17, 2008).

25 One might assume that tax preparers would know about the credit. Yet IRS data show that 16 percent of practitioner-prepared returns failed to claim the credit. IRS Office of Research, Analysis, and Statistics, Response to TAS Information Request (Dec. 17, 2008).

26 *See* IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts *at* http://www.irs.gov/newsroom/article/0,,id=154496,00.html). As low as these rates are, they would be even lower if not for the fact that some of this income is reported to the IRS by third parties.

27 *See* IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006).

28 IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2001).

The National Taxpayer Advocate believes the answer is partly attributable to the sense of affinity and unity that individuals feel with local organizations and the relative disconnect that they feel with the government. Stealing from a local charity feels like stealing from family and friends, yet cheating on one's taxes feels to many like a victimless offense.

We suggest there are two reasons for this disconnect and that tax reform can and should address them. First, members of a community generally understand the services that local organizations provide and the benefits that they personally derive. By contrast, many Americans do not understand how their tax dollars are spent or how they benefit.

Second, the complexity of the tax code obscures understanding, with the result that taxpayers often have little idea how much they are paying or why. They also worry that they are missing tax breaks while others are benefiting from too many breaks. This is hardly surprising when Congress annually is making hundreds of changes to the tax code, while at the same time, the press is filled with stories about corporate tax shelters and foreign bank accounts used by "other" taxpayers to shield income from the IRS.

In our view, the existing tax system perpetuates the sense of distance that many taxpayers feel from their government, and tax compliance rates suffer. This may seem abstract, but voluntary compliance is central to our tax system, so this "distance" must be addressed. We believe that simplifying the tax code would be a big step in the right direction. We also believe that providing taxpayers with a "taxpayer receipt" showing how their tax dollars are being spent could help bridge the disconnect by allowing taxpayers to see concretely what benefits they are receiving in exchange for their tax dollars.[29]

4. The Tax Code Is So Complex That the IRS Has Difficulty Administering It.

The IRS employs about 100,000 workers[30] and generally performs very well, but it faces daunting challenges in running the tax system. Despite the fact that about 90 percent of taxpayers rely on preparers or tax software packages, the IRS received 110 million calls in each of the last two fiscal years.[31] That is a staggering number, and not surprisingly, the IRS was unable to answer more than 25 percent of them.[32] In fiscal year (FY) 2008, the IRS received approximately 167 million calls overall,[33] largely inquiries generated by the Economic Stimulus Act, and was only able to answer 53 percent.[34]

29 The IRS publishes a pie chart that provides a breakdown of the major categories of federal spending. *See* IRS Form 1040 Instructions (2009), at 100. However, most taxpayers never see this chart. Fewer than ten percent of taxpayers prepare their returns by hand, and even among that group, few likely take the time to read through the 175-page instructions booklet in which the pie chart is contained. We therefore recommend that a "taxpayer receipt" be provided to all taxpayers and that it present a somewhat more detailed breakdown of federal spending than the chart.

30 IRS Data Book, 2009, Table 31 *at* http://www.irs.gov/pub/irs-soi/09db31ps.xls.

31 IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (weeks ending Sept. 30, 2009 and Sept. 30, 2010).

32 The Customer Account Services Level of Service was 70 percent in FY 2009 and 74 percent in FY 2010. *See* IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services – CAS* (weeks ending Sept. 30, 2009 and Sept. 30, 2010). These percentages reflect the number of calls that reached telephone assisters among all calls seeking to do so.

33 IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (week ending Sept. 30, 2008).

34 IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services – CAS* (week ending Sept. 30, 2008).

Other challenges facing the IRS are described throughout this report. To cite one example, the IRS cannot process on a timely basis a considerable portion of the more than 11 million pieces of taxpayer correspondence it receives each year. This situation leads to erroneous tax assessments, improper collection actions, additional penalties and interest for taxpayers, and additional refund interest costs to the government.[35] To cite another example, the IRS relies heavily on automated processes to achieve efficiencies, but in doing so, it sometimes fails to address the unique circumstances of individual taxpayers. The dramatic increase in automated lien filings over the past decade and the IRS's unwillingness to require its employees to make individualized lien determinations are also described in this report.[36]

Simply put, additional tax code complexity will further strain the IRS's ability to serve taxpayers, while a simpler code will make the job of the tax administrator much easier – something that would benefit both taxpayers and the government.

B. Since There Is General Sentiment That the System Is Broken, Why Isn't It Being Fixed?

There is a widespread belief that the influence of "special interests" is the biggest roadblock to comprehensive tax reform. There is no doubt that many provisions in the tax code benefit narrow groups of taxpayers, including several described above. But the dirty little secret is that the largest special interests are us – the vast majority of U.S. taxpayers. Virtually all of us benefit from certain exclusions from income, deductions from income, or tax credits (collectively known as "tax expenditures").[37]

In December 2010, the Joint Committee on Taxation published its annual analysis of tax expenditures for the five-year period FY 2010 through FY 2014, and the largest tax expenditures were the following:[38]

- The exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance ($659.4 billion).
- The exclusion for retirement plan contributions and earnings ($596.5 billion).[39]
- The mortgage interest deduction for owner-occupied housing ($484.1 billion).

Most Serious Problems

35 *See* Most Serious Problem: *The IRS Does Not Process Vital Taxpayer Responses Timely, infra.*

36 *See* Status Update: *The IRS Has Been Slow to Address the Adverse Impact Its Lien Filing Policies Have on Taxpayers and Future Tax Compliance, infra.*

37 When Congress wishes to spend money, it may do so in either of two ways. It can make expenditures directly via cash outlays, or it can make expenditures by providing tax breaks through the tax code. This latter category of spending is referred to as "tax expenditures." A tax expenditure is essentially any reduction in income tax liability that results from an exclusion, exemption, or deduction from gross income or a credit, preferential tax rate, or deferral of tax. As a practical matter, a tax expenditure has the same impact as a government spending program. Assume that an individual facing a 25 percent tax rate pays $10,000 in mortgage interest and that the government wants to provide a subsidy for home ownership. It could accomplish this objective in two ways: (1) it could allow the taxpayer to deduct the $10,000 of mortgage interest from his gross income, which would produce a tax reduction of $2,500, or (2) it could make a direct payment of $2,500 to the taxpayer in lieu of the tax deduction. The taxpayer ends up in the same economic position either way. For a detailed discussion of tax expenditures, see *Evaluate the Administration of Tax Expenditures*, vol. 2, *infra*.

38 *See* Staff of the Joint Committee on Taxation, 111th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014*, Table 1 (Joint Comm. Print 2010).

39 This total represents the sum of defined benefit plans ($303.2 billion), defined contribution plans ($212.2 billion), and plans covering partners and sole proprietors (sometimes known as "Keogh" plans) ($81.1 billion).

- The reduced rates of tax on dividends and long-term capital gains ($402.9 billion).
- The exclusion for various Medicare benefits ($337.1 billion).[40]
- The earned income tax credit ($268.8 billion).[41]
- The deduction for nonbusiness state and local taxes ($237.3 billion).
- The exclusion of captain gains at death ($194.0 billion).
- The deduction for charitable contributions ($187.5 billion).

As this list illustrates, the big-ticket items do not benefit narrow special interests. They benefit large segments of the taxpaying public. Moreover, many of these tax breaks are designed to promote objectives that most taxpayers would consider desirable. The mortgage interest deduction is designed to promote home ownership. The employer exclusion for health care-related benefits is designed to encourage employers to provide health insurance coverage for their workers. The exclusion of retirement plan contributions is designed to encourage Americans to save for retirement. The EITC provides a credit for low income individuals who hold jobs, seeking to encourage work and raise them out of poverty. Finally, the deduction for charitable contributions is designed to encourage taxpayers to support charities and other nonprofit organizations that seek to advance the public good.[42]

As the magnitude of the numbers suggests, however, tax expenditures have a huge impact on the public's attitude toward tax reform. In theory, most of us agree that the tax code is too complex and that broadening the tax base by eliminating existing tax breaks in exchange for lower rates would improve the system.[43] In practice, the prospect of lower rates may seem speculative and distant, while the threatened loss of existing tax breaks raises immediate concerns. Thus, taxpayers require some reassurance that the loss of their tax breaks will indeed be accompanied by a corresponding reduction in rates.

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40 This total represents the sum of hospital insurance - Part A ($175.8 billion), supplementary medical insurance - Part B ($124.5 billion), prescription drug insurance - Part D ($35.1 billion), and exclusion of certain subsidies to employers who maintain prescription drug plans for Medicare enrollees ($1.7 billion).

41 This account reflects the full value of the EITC, including the refundable portion associated with significant outlay effects. *See* Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014*, Table 1, at 52 n.5.

42 Despite the best of intentions, the evidence is mixed concerning the extent to which these tax incentives encourage more of the behavior they seek to induce. For a more complete discussion, see Volume 2, *Evaluate the Administration of Tax Expenditures*, of this report.

43 The bipartisan fiscal commission appointed by the President recently made recommendations along these lines. *See* National Commission on Fiscal Responsibility and Reform, *A Moment of Truth*, at 15, 28-34 (Dec. 2010) *at* http://www.fiscalcommission.gov/news/moment-truth-report-national-commission-fiscal-responsibility-and-reform.

C. Tax Reform Is Personal: We Must All "Give at the Office."

Overall, the Joint Committee on Taxation estimates that tax expenditures total about $1.1 trillion a year.[44] As compared with about 138 million tax returns filed in 2010,[45] that amounts to an average reduction in tax per return of about $8,000.[46]

Because tax is computed as a percentage of income, a taxpayer who pays tax at a rate of 25 percent would be receiving the benefit of deductions or exclusions from income worth $32,000 (*e.g.,* if an individual's deductions for mortgage interest and charitable contributions and exclusions from income for employer-provided health insurance, retirement plan contributions and transportation subsidies total $32,000, the tax savings would come to $8,000 at a 25 percent rate).[47]

Example

> A single parent with two minor children has an adjusted gross income of $100,000 in 2010. He receives the benefit of "tax expenditures" totaling $32,000 (consisting of exclusions for employer-provided health insurance and retirement plan contributions and deductions for mortgage interest, state and local taxes, and charitable contributions). In addition, he receives the benefit of three personal exemptions – one for himself and one for each child, totaling $10,950.[48] Therefore, the taxpayer reduces his $100,000 adjusted gross income by $42,950 (the sum of total tax expenditures for which he qualifies and three personal exemptions) to arrive at a taxable income of $57,050. Under the 2010 rate tables, the taxpayer owes federal income tax of $9,110. Thus, this taxpayer is actually paying a marginal tax rate of 25 percent, but he ends up paying an average rate of tax of about nine percent.[49]

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44 *See* Staff of the Joint Committee on Taxation, 111th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014* (Joint Comm. Print 2010). The Joint Committee provides a separate estimate for each tax expenditure, but it does not add them up to provide an aggregate total. Tax expenditures have interactive effects for which the Joint Committee has not attempted to account. If those effects were incorporated, the aggregate total of foregone revenue would be somewhat lower. Nevertheless, the aggregate total provides a reasonable approximation of the level of tax expenditures, and we use it in this report for that purpose.

45 *See* IRS 2010 Filing Season Statistics *at* http://www.irs.gov/newsroom/article/0,,id=220953,00.html.

46 As discussed in a prior footnote, tax expenditures have interactive effects, so if all tax expenditures were simultaneously eliminated, the change in revenue would likely be somewhat less than $1.1 trillion. Accordingly, the average tax reduction per taxpayer could be somewhat less than $8,000. Nevertheless, this total represents a reasonable approximation and is used for illustrative purposes in this report. *See* Leonard Burman, Eric Toder & Christopher Geissler, *How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?* Discussion Paper 31, Amer. Soc. Sci. Assoc'n (New Orleans, La., Jan. 5, 2008) 3, shorter version published in 98 *Amer. Econ. Rev*. 79 (2008) (stating that despite interaction effects, "commentators have added up tax expenditures to make general statements about their magnitude").

47 Some tax expenditures disproportionately benefit higher income taxpayers. Therefore, the dollar value of tax expenditures is likely to be somewhat lower than $8,000 for a typical taxpayer.

48 The Joint Committee on Taxation does not consider either personal exemptions or the standard deduction to be tax expenditures because they "defin[e] the zero-rate bracket that is a part of normal tax law." *See* Staff of the Joint Committee on Taxation, 111th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014*, at 4-5 (Joint Comm. Print 2010). Therefore, they reduce taxable income further.

49 Because tax rates rise with income, this taxpayer pays tax at 10 percent on his first $11,950 of taxable income, at 15 percent on taxable income between $11,950 and $45,550, and at 25 percent on his additional income. We are assuming that this taxpayer chooses to file using the head-of-household filing status.

We are not advocating for a flat tax or recommending that all tax expenditures be terminated. For purposes of illustrating the magnitude of existing tax expenditures and the complexity of the computations, we provide this example simply to note that the government could raise the same level of revenue by taxing this individual at a tax rate of about nine percent.

The concept of tax expenditures is not widely understood. We suspect many taxpayers would instinctively recoil at the thought of surrendering $32,000 in tax breaks because they would assume their overall tax burden would skyrocket. If, however, a typical taxpayer were asked if she would be willing to give up $32,000 in tax breaks in exchange for substantially lower rates that would leave her overall tax burden unchanged, we think her reaction would be overwhelmingly positive.

Consider another example: The Alternative Minimum Tax (AMT) is perhaps the most reviled provision of the tax code.[50] But it is important to recognize that the AMT does not exist in a vacuum. Rather, the AMT is a monument and an intended antidote to tax expenditures run amok. Congress first enacted a minimum tax in 1969 because of concerns that wealthy taxpayers were taking advantage of tax expenditures to the point that some were paying little or no tax. The Senate Finance Committee report that accompanied the provision stated:

> Under present law, many individuals and corporations do not pay tax on a substantial part of their economic income as a result of the receipt of various kinds of tax-exempt income or special deductions. . . . [T]he committee believes that an overall minimum tax on tax preferences is . . . needed to reduce the advantages derived from these preferences and to make sure that those receiving such preferences also pay a share of the tax burden.[51]

The AMT continues to serve this same function today, if imperfectly. In a world without tax expenditures, the AMT would have no place.

If tax reform is to gain traction, the key challenge will be to persuade taxpayers that they personally, and the system as a whole, will be better off if many targeted benefits are eliminated in favor of lowering tax rates for substantially all U.S. taxpayers.

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50 The National Taxpayer Advocate has repeatedly identified the AMT as a serious problem for taxpayers and has recommended its repeal in prior reports and congressional testimony. *See* National Taxpayer Advocate 2008 Annual Report to Congress 356-362 (Legislative Recommendation: *Repeal the Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2006 Annual Report to Congress 3-5 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2004 Annual Report to Congress 383-385 (Legislative Recommendation: *Alternative Minimum Tax*); National Taxpayer Advocate 2003 Annual Report to Congress 5-19 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2001 Annual Report to Congress 166-177 (Legislative Recommendation: *Alternative Minimum Tax for Individuals*); *see also Alternative Minimum Tax: Hearing Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways & Means* (Mar. 7, 2007) (statement of Nina E. Olson, National Taxpayer Advocate); *Blowing the Cover on the Stealth Tax: Exposing the Individual AMT: Hearing Before the Subcomm. on Taxation and IRS Oversight of the Senate Comm. on Finance* (May 23, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

51 S. Rep. No. 91-552, at 111-112 (1969).

As the statutory voice of the taxpayer, the National Taxpayer Advocate believes that tax reform is essential and urgent, but it must not be rushed. Tax reform should not be imposed on taxpayers. Rather, it should be shaped with taxpayer engagement and support. Ultimately, taxpayer involvement will lead to a better result, and equally important, it will make taxpayers feel more connected with the end product, which could lead to compliance gains as well.

The key is that in conducting this dialogue, we must be honest. We cannot pretend that broadening the tax base means eliminating someone else's tax break while preserving our own. Everything must be put on the table, and we must make clear that, in exchange for lower rates, some tax breaks will be eliminated immediately and others will be phased out.

But it is equally important to make clear that, assuming revenue neutrality, the average taxpayer will not pay more tax and the tax code will be much easier to understand and comply with. Taxpayers would have a better understanding of how their tax liabilities are computed, would have more confidence that the system is treating them fairly relative to others, and would save time and money preparing their returns because they could do the job quickly themselves.

Based on all the comments we receive in the Taxpayer Advocate Service and our experience in handling some 300,000 taxpayer cases a year, lowering rates in exchange for broadening the tax base seems like an excellent bargain. We are confident that in the end, public support for a simpler code will be strong and deep.

D. It May Be Prudent to Keep Consideration of Structural Tax Reform Separate From the Debate Over Revenue Levels.

Although our office does not take a position on fiscal policy issues or tax rates, we are mindful that leaders of both parties have expressed deep concerns about the long-term structural imbalance between government revenues and government spending, and that in addition to spending cuts, tax revenues at some point may have to be increased. We are also mindful that the question of whether and to what extent to raise revenue is extremely contentious.

If structural tax reform and revenue levels are considered together as part of a package, we are concerned that the debate over revenue levels could overshadow and derail meaningful tax reform. Therefore, we suggest that Congress consider addressing these issues separately. First, Congress could enact structural tax reform on a revenue-neutral basis. Second, Congress could decide on appropriate revenue levels and adjust the tax rates as it deems appropriate.

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress substantially reform and simplify the Internal Revenue Code. Some specific simplification suggestions are discussed in the Legislative Recommendations section of this report.

To enhance taxpayer awareness of the connection between taxes paid and benefits received, the National Taxpayer Advocate further recommends that Congress direct the IRS to provide all taxpayers with a "taxpayer receipt" showing how their tax dollars are being spent. This "taxpayer receipt" could be a more detailed version of the pie chart currently published by the IRS and would be provided directly to each taxpayer.[52] For the reasons discussed above, we believe better public awareness of the connection between taxes and government spending may improve civic morale, improve tax compliance, and make more productive the national dialogue over looming fiscal policy choices.

52 *See* IRS Form 1040 Instructions (2009), at 100.